

# **Economic Policy Challenges for Belgium**

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**GERT PEERSMAN  
(UGENT)**

**STIJN VAN NIEUWERBURGH  
(NYU, NBER, CEPR)**

# Some Unpleasant Belgian Fiscal Arithmetic

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- Some Belgian politicians believe we can just eliminate the deficit and grow out of our high debt-to-GDP ratio by riding out the favorable business cycle, in the slipstream of Germany
- Others think we will have to save, but without touching social security expenditures (pensions, government benefits, and health care)
- Our simulations show that neither is realistic

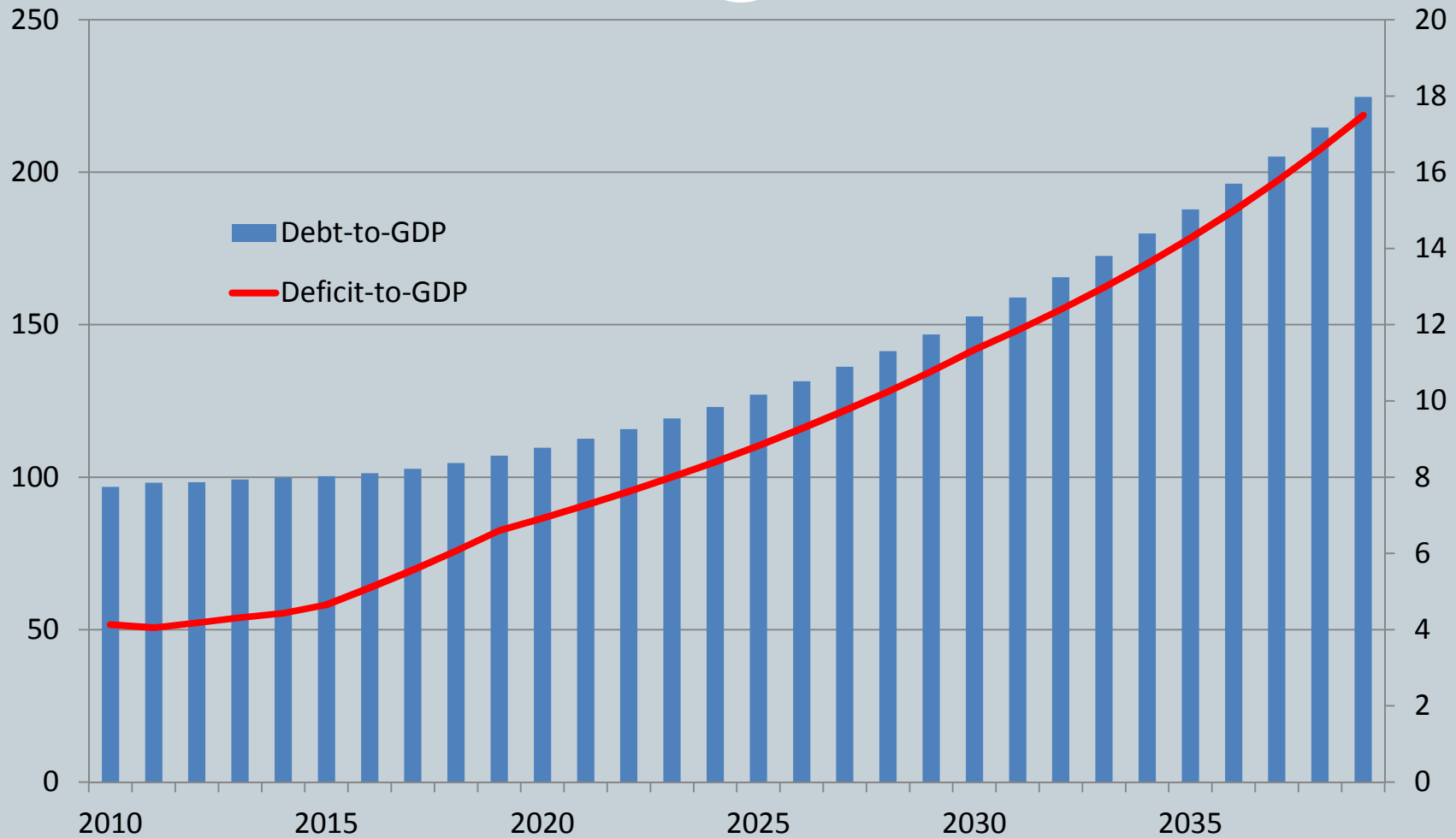
# Our Simulation

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- From 2010 until 2060
- Assumes that the government
  - Enjoys the cyclical windfalls from 2011-2015 (1.5% of GDP)
  - Enjoys higher productivity growth than past 20 years after
  - Gradual rise in labor market participation rate and fall in unemployment after 2015 below historical minimum
  - Faces cost of ageing rising by 1.4% of GDP by 2015 and an additional 5.2% from 2015 to 2060
- Scenario 1: Keeps discretionary structural spending at 21% of GDP (2010 level )

# Scenario 1: Exploding Deficit and Debt

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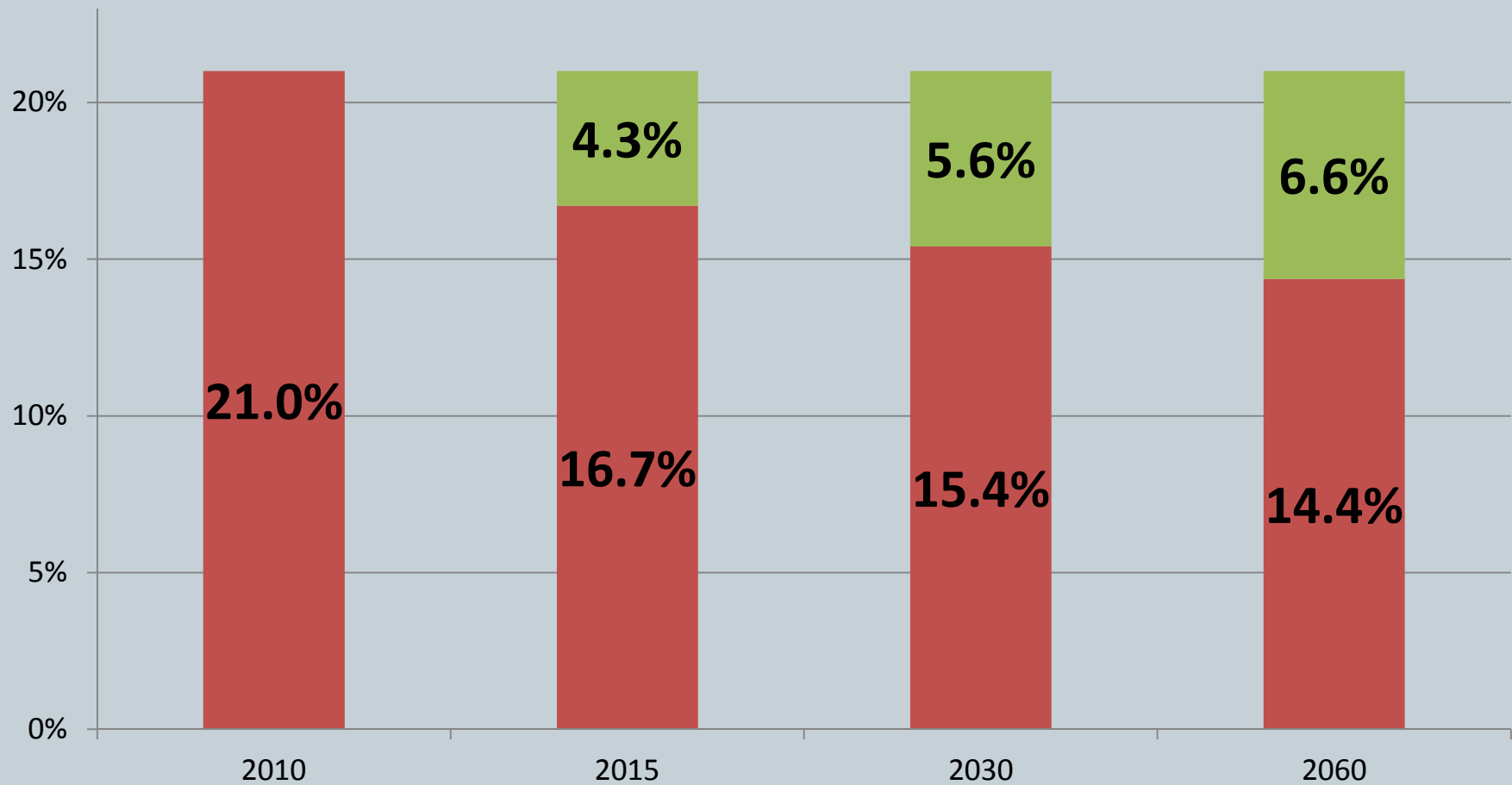
# Cutting Discretionary Structural Spending?

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- Belgium has submitted a plan to return to budget balance by 2015
- How to get to a balance budget from 2015 onwards?
- Scenario 2: cut discretionary (non social security) structural spending, government revenue constant
- Same favorable assumptions as before
- **How much does discretionary structural spending have to fall to achieve budget balance in 2015 and beyond?**

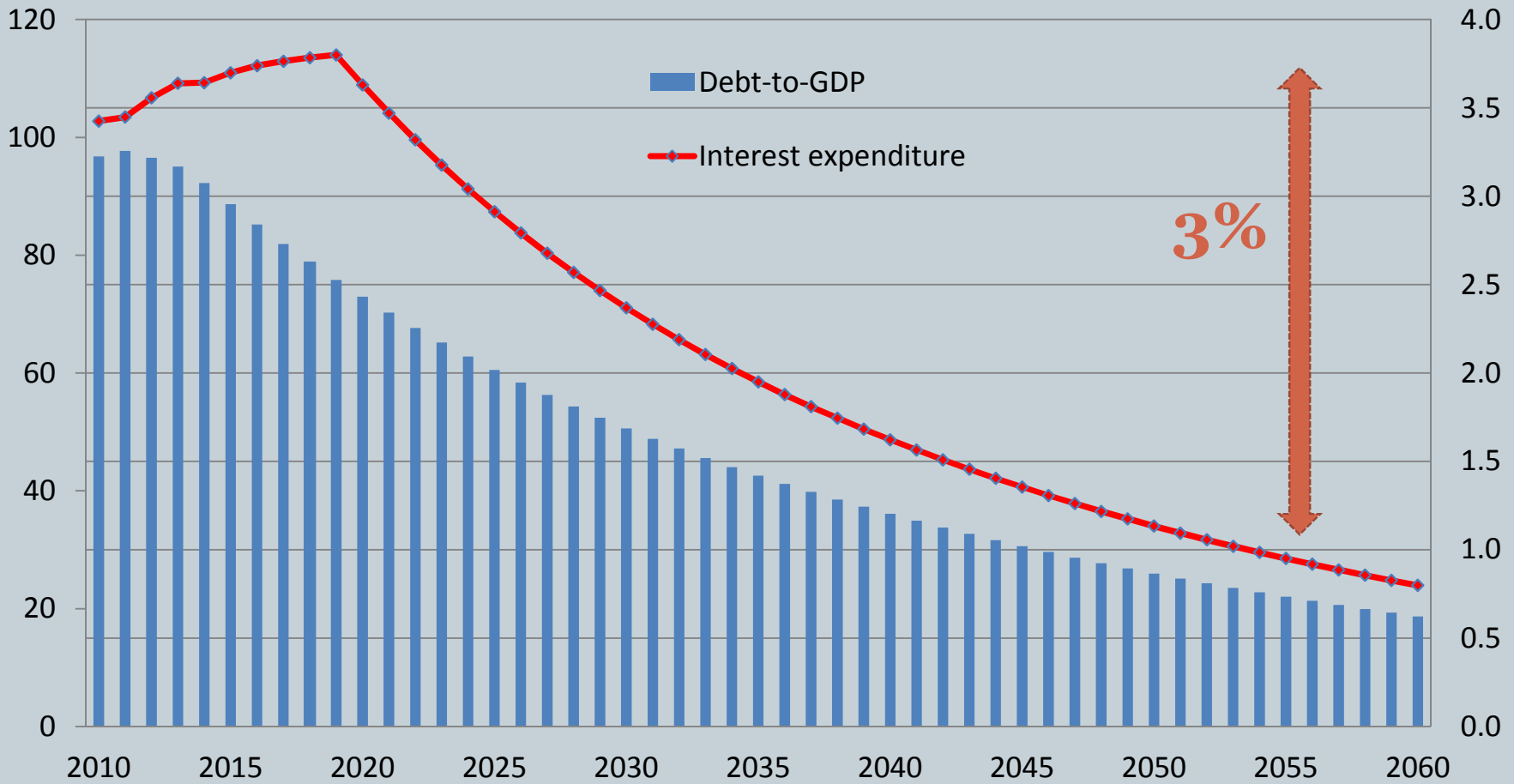
# Scenario 2: Visualizing the Cuts

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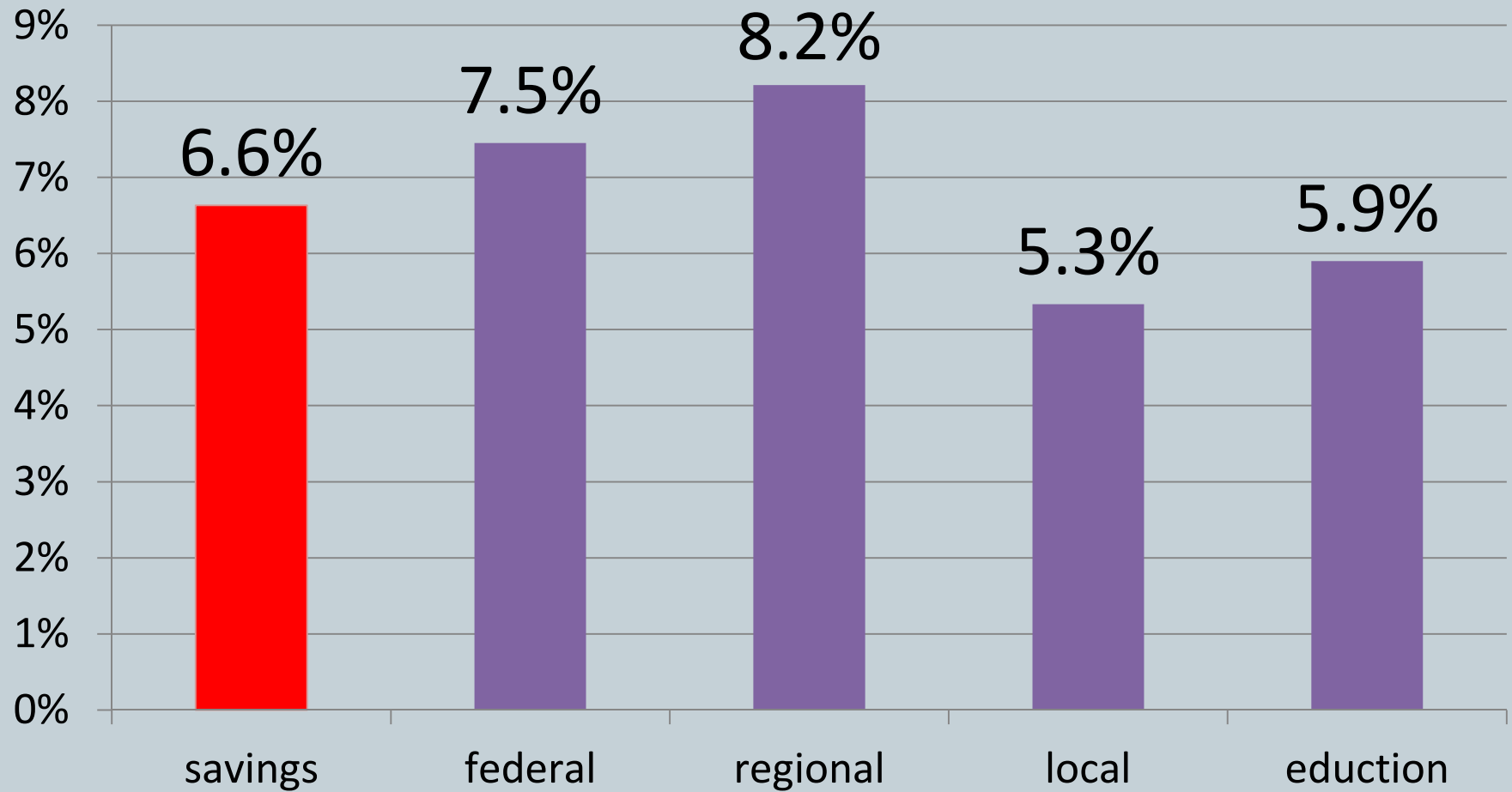
# Debt Stabilization

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# More Unpleasantness

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# Risks are on the Downside

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- What if productivity growth does not increase above the past two decades?
- What if employment rates do not improve as foreseen?
- What if the relative price of health care does not remain constant?
- What if interest rates rise unexpectedly?
- What if the political situation does not improve and Belgian debt is downgraded?
- What if we have a European sovereign/banking crisis?
  - Massive bank bailout of 27.5% of GDP in 2008-09

# Cap Cost of Ageing

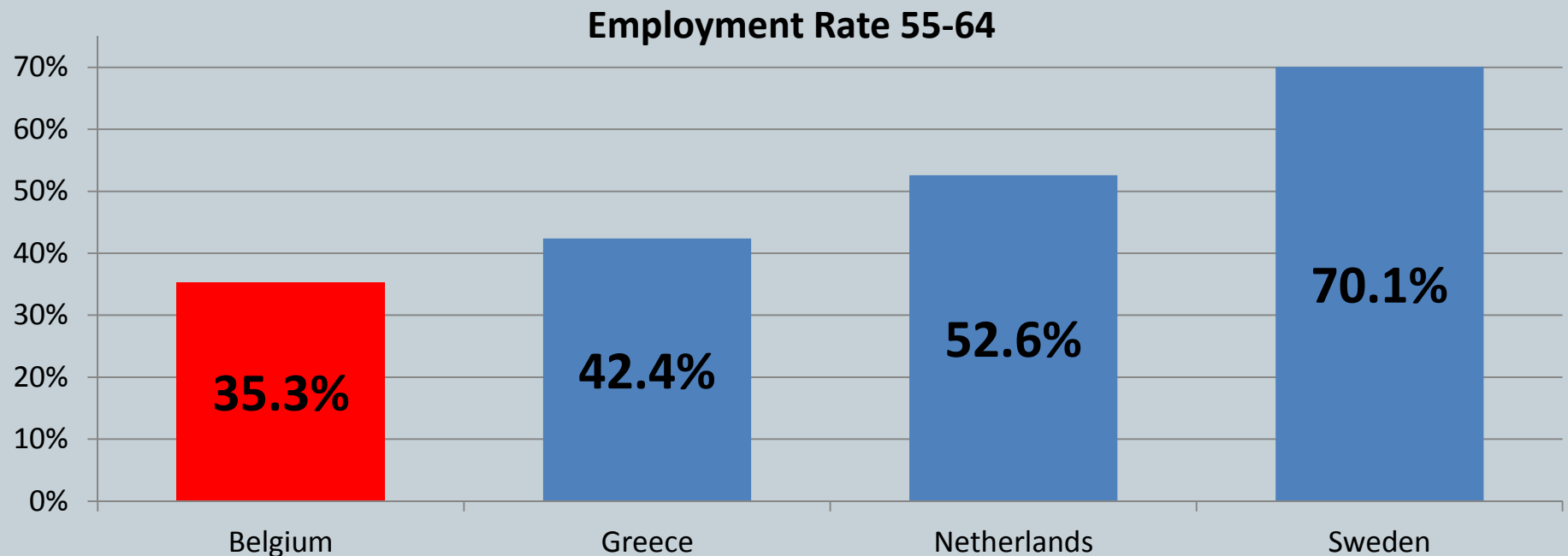
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- Must combine discretionary spending cuts with labor market, pension, and health care reform
  1. Cap rise in health care costs
  2. Increase pension age
  3. Make work pay
  4. Abolish current system of automatic wage indexation

# Pension Reform

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- Share of dependent population: set to increase from 34.4% in 2008 to 42.4% in 2050
- Effective retirement age currently 59.7 years



# Pension Reform

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- Current projections: rise of effective retirement age to 61.7 and increase of employment rate 55-64 to 50% by 2050
- Belgium should **increase** the employment rate among 55-64 year olds **further** to 70%
  - Making early retirement less attractive and curtailing the bridge pension system
- Belgium should **raise the official pension age** for men and women **to 67** and index it to life expectancy

# Making Work Pay

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- **Small labor – unemployment wedge**
  - Belgium has the highest average labor cost in the business economy of any European country (incl. 55% total labor taxes)
  - High marginal labor taxes for low-wage earners
  - Unemployment benefits generous and unlimited in duration
- **A lot of labor market rigidity and employment protection**
- **Results in overall low employment rates (62% or 8% below Lisbon goal), long unemployment duration, and labor market tightness**

# Making Work Pay

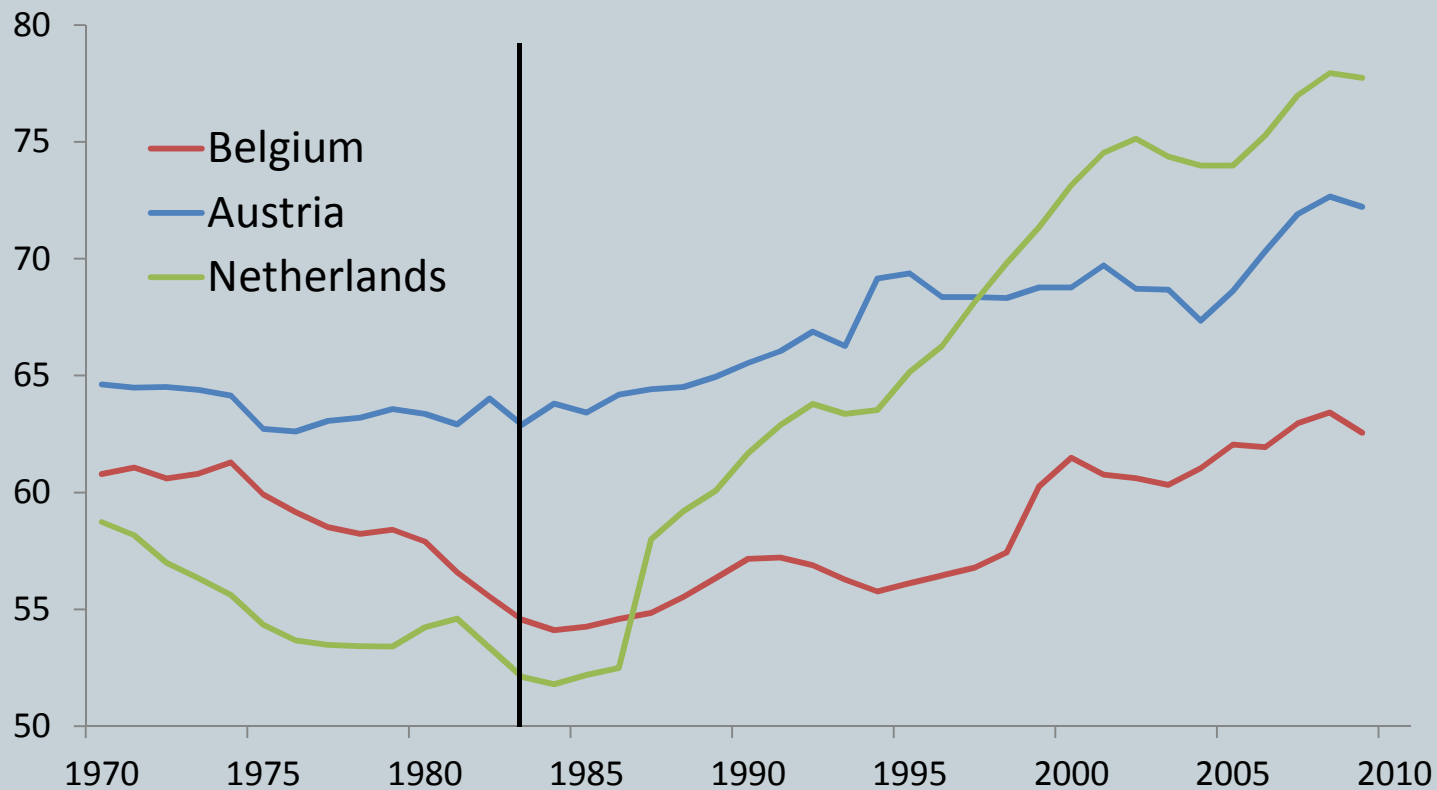
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- **Increase gap** between low wages and unemployment benefits by
  - Making unemployment benefits limited in duration and decreasing over time
  - Lower taxes for low-wage earners down from current 25%
- As job search theory suggests, benefits exhaustion increases incentives to search for and accept a job
- **Reduce marginal tax rate on labor** more generally; increase VAT and energy taxes to make it budget neutral

# Automatic Wage Indexation

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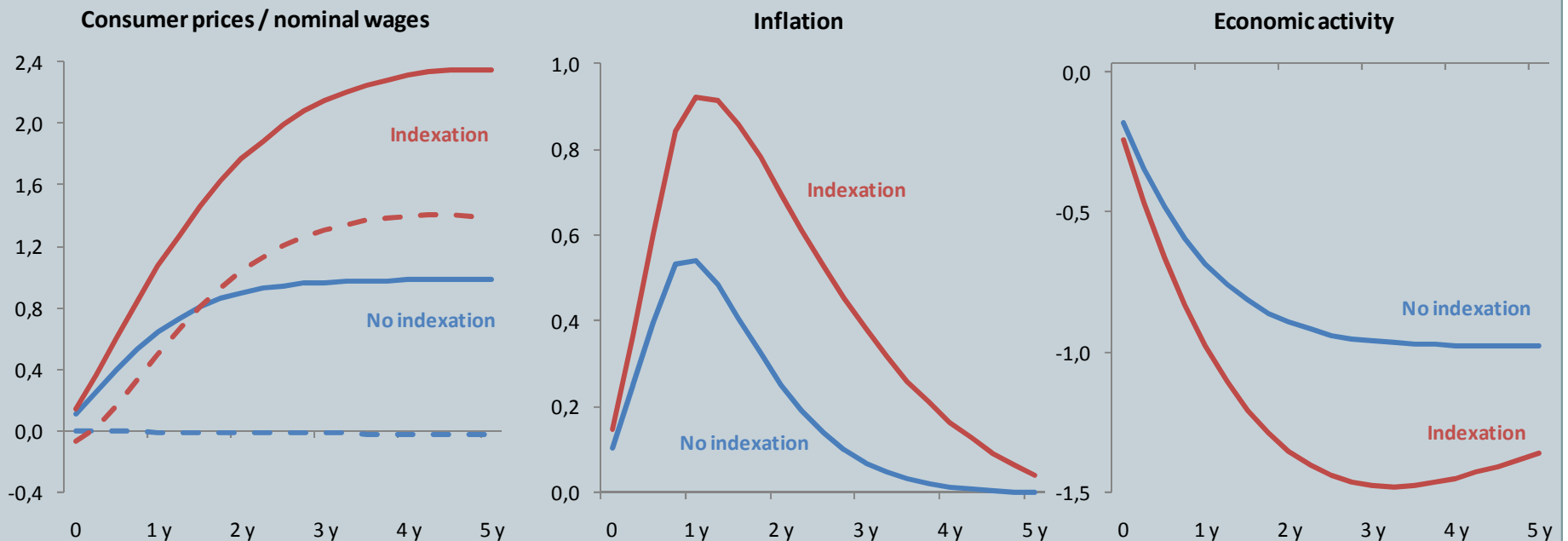
- Belgian wages automatically indexed to realized inflation: reduces employment rate



# Second Round Effects

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- Inflation targeting ECB and harmful wage-price spirals
  - Second-round effects in part of Euro Area require more aggressive monetary policy response to deviations of inflation from target
  - Hence, stronger output consequences





# Negative Externalities

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- Monetary policy response imposes negative externality also on European countries that do not index wages to realized inflation
- Even more harmful for Belgium economic activity because indexation adversely affects competitiveness
- Gradual reduction of employment rate over time
  - Causes (relative symmetric) excess fluctuations in prices
  - Impact on employment not symmetric because of labor market rigidities

# Our Proposal

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- **Index wages to inflation target of ECB**, which is 2% per year, not more or less
- Preserves purchasing power (inflation was 1.97% since start euro) and social peace of current system
- Eliminates externalities of second round effects
  - Makes it easier for ECB to reach target
- Competitiveness in lock step with European average
- Improves employment rate
- Additional benefits: lower risk for deflation spiral, stabilizes business cycle, disciplines price setters

